Fair Trading Commission

Commissioners' Decision

Case 3263

Telstar Cable Ltd. on Predatory Behaviour

August 29 , 2001

Public Version
Confidential information omitted. The omissions are indicated by a note or by the symbol ✄

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1. The Allegation

1.1 The complaint was lodged with the Fair Trading Commission (FTC) on December 8, 1999.

1.2 The Informant, Entertainment Systems Limited (henceforth "Entertainment Systems"), is of the view that the offer made by Telstar Cable (henceforth "Telstar") in an advertisement, which appeared in the November 28, 1999 edition of the Sunday Gleaner, is aimed at eliminating it from the market. The advertisement offered three months of free cable service to subscribers who switch from another cable company within the month of December 1999.

2. The Fair Competition Act

2.1 Competition lies at the heart of any successful market economy and is crucial to the protection of consumers' interests and the efficient allocation of resources. It is a process whereby firms constantly try to gain an advantage over their rivals and win more business by offering more attractive terms to customers or by developing better products or more effective ways of meeting their requirements. Competition has several dimensions of which price is only one, albeit in many markets the most important. It encourages the development of new or improved products or processes and, in the long run, enhances economic growth and living standards. The objective of the Fair Competition Act (FCA) is therefore to ensure that the benefits of the competition process in Jamaica are unhindered by anti-competitive activity.

2.2 The allegation brought forward by Entertainment Systems against Telstar falls under Section 20 of the FCA, which prohibits the abuse of dominance. Under Section 20(1), an enterprise would be considered to have abused a dominant position if it impedes the maintenance or development of effective competition in a market. For the purposes of the Act an enterprise holds a dominant position in a market if by itself or together with an interconnected company, it occupies such a position of economic strength as will enable it to operate in the market without effective constraints from its competitors or potential competitors.

2.3 Subsection 20(1)(d) states that an enterprise abuses a dominant position if it "directly or indirectly imposes unfair purchase or selling prices or other uncompetitive practices". The Commission interprets section 20(1)(d) to include "predatory pricing". Behavior that may constitute predatory pricing and the general methodology of investigation is discussed in section 3. Section 4 analyses the allegation of predatory pricing against Telstar using the principles detailed in section 3.

3. Predatory Pricing under the Fair Competition Act

3.1 Predatory behavior constitutes a class of anti-competitive behavior where prices are set so low so as to eliminate some undertakings and threaten the competitive process itself. In these circumstances, consumers may benefit in the short run from lower prices, but in the longer term, weakened competition will lead to higher prices, reduced quality and less choice.

3.2 Distinguishing predatory behavior from legitimate competition is difficult. Since the main objective of competition policy is to create conditions where consumers benefit from effective competition, the distinction must be drawn between low prices that result from predatory behavior, and low prices that result from legitimate competitive behavior. Indeed, it must be noted that *structural* conditions in most markets do not allow for predation. As summed up by the OECD:

> "Perhaps all that can be said is that cases of predation may arise but at most only very infrequently. Complaints of predation, however, are presented to competition authorities with some regularity, although the great majority of these cases involve nothing more than healthy price competition. Thus, competition authorities need some method to separate systematically the occasional violation from numerous complaints."[1]

3.3 In Canada, for example, some 550 complaints alleging an offense under the predatory pricing provisions were lodged between 1980 – 1990. Of those complaints, only 23 resulted in formal inquiries under the Competition Act, four were referred to the Attorney General and only three resulted in the laying of charges.[2] This observation is supported by the U.S. Supreme Court who notes that "predatory pricing schemes are rarely tried, and even more rarely successful".[3]

3.4 There are three key elements to predatory behavior:

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[1] OECD, *Predatory Pricing* (1989).

[2] Director of Investigation and Research, *Predatory Pricing Enforcement Guidelines.* Competition Act. Canada (1992).

[3] In Matsushita Electric Industry Co., Ltd. V. Zenith Radio Corp., 475 U.S. 574, 589 (1986).

- *Intent*—Predation does not happen 'by coincidence'. There must be first an intention to predate. Nevertheless, intent is a subjective concept and difficult to determine. Sometimes intent is inferred if an incumbent reduces price upon entry of new competitor, therefore forcing the new competitor to exit, and subsequently raises price back to its original level. Such behavior, however, may also obtain under competitive circumstances. After all, new entry raises overall market output and forces the incumbent to decrease its price or else concede market share. Such a price reduction often is not predatory but is instead a natural response to the increased competition. If the new entrant is, for example less efficient than the incumbent, such that its costs are higher than the new market price, it will exit the market. The exit of a new entrant in this manner, commonly observed in reality, is part and parcel of the natural workings of the free market. That is to say, not all entry is efficient and not all exit is inefficient, even in an industry with a dominant incumbent.

  Besides, boardroom talk and statements in internal memos revealing the intentions to "squish rivals like a bug" or "pound them into the sand" – phrases that at times show up as evidence in predation cases – are also entirely consistent with fierce but healthy competition.

- *Feasibility*—certain structural conditions of the market must exist for predation to be feasible. Specifically, successful predation requires market power during the predation period. This is because the predator must expand output in order to depress the overall market price and put pressure on his rivals. To have a strong impact on market price, the predating firm would need a sufficiently high market share from the start. Otherwise the predating firm itself will not be able to survive through the predation period. Moreover, if market demand is elastic, the predator must take on extra sales at a loss to satisfy the new demand that is created at the lower price, apart from the extra sales it has to take over from its victims. All this makes predatory pricing in fact more costly – at least in the short term – for the predator than its victims. For this reason, predatory pricing almost always comes under the category of abuse of dominance, where dominance must first be established.

3.5 Furthermore, predation involves the predator incurring short run losses so that it can increase profits in the long run. In the short run, it incurs losses in order to eliminate competitors. In the long run, it will expect to recoup the losses by charging higher prices (or offering less favorable terms). Predation works only if the firm will be able to recoup its short run losses by charging higher prices in the future – which will be possible only if the undertaking will not face significant competition *in the future*, from new entrants, for example.

3.6 While *future* market power is distinct from *current* market power, a currently dominant undertaking can be expected to retain future dominance and to recoup losses following predatory action. In other words, the market structure is likely to be retained. A scenario in which current market power may differ from future market power could arise where a dominant undertaking is alleged to be engaging in predation in a *related* market, but one in which it is not currently dominant.

Even so, if future dominance in the related market arises following successful predation, the undertaking would have an ability to recoup its short-run losses.

- *Execution*—Finally a pricing policy that is in some way below cost in a manner that is consistent with the intention to predate must be implemented.

3.7 All these three elements must be present for a genuine case of predatory pricing to exist. The following discusses a methodology for investigating allegations of predatory pricing.

Predatory pricing: investigation guidelines

3.8 Many competition authorities apply a two-step method in investigating predatory pricing.[4] The first step is to determine the feasibility of market structure for predation. If the structural conditions are considered not to be feasible for successful predation, the conclusion drawn is that there is no predation and the investigation terminates.

3.9 If the structural conditions suggest that successful predation is feasible, however, then the second step is implemented whereby a price-cost comparison is carried out to determine if below cost pricing has been implemented in a manner that could be considered predatory. Both these steps – market structure and price-cost analyses – are further explained below. Intent is normally not taken into consideration in the analysis as it is highly improbable that strong evidence would exist.

Step 1: Analysis of market structure

3.10 For reasons discussed above, a pre-condition for successful predation is a market structure in which the undertaking has sufficiently large market share. It is common practice amongst competition authorities to apply the test of dominance as a pre-requisite for predation. Dominance is commonly defined as a position of economic strength that enables an undertaking to operate in the market without effective constraints from its competitors or potential competitors.[5] Put differently, a dominant firm is one that is able to behave to an appreciable extent independently of its competitors, customers and ultimately of consumers.[6] Therefore, the first step in the investigation is to determine if the undertaking is dominant in the *relevant* market. Dominance is usually determined by consideration of market shares and barriers to entry.

3.11 *Market* shares—a market share of between 40 – 50% is commonly used by competition authorities as a guideline threshold for dominance. The European Court, for example, has stated that dominance can be presumed in the absence of evidence to the contrary if an undertaking has a market share persistently above

[4] For example, in the United Kingdom and Canada.
[5] See section 19 of the Fair Competition Act.
[6] See, for example, the definition taken by the European Court in Case 27/76 United Brands v EC Commission [1978] ECR 207, [1978] 1 CMLR 429.

50%.[7] The Office of Fair Trading in the UK considers it unlikely that an undertaking will be individually dominant if its market share is below 40%.[8]

3.12 These are, however, guideline thresholds that are not set in stone. Dominance could be established even below the 40% threshold if other relevant factors, such as weak position of competitors in that market provided strong evidence of dominance. If, for example, the largest player in the market has 30% market share and many other small firms, none possessing more than 3% or the market, sharing the remainder of the market. In this scenario, 30% market share could be sufficient to meet the dominance test.

3.13 Consider another scenario in which a market is equally shared between two players, each accounting for 50% of the market. In this case, collusive behavior aside, neither of them can be said to be truly dominant as neither is therefore likely to be able to act independently of the other. Actions of one player are likely to be met by equally forceful reactions from the competitor who himself commands a similar degree of market power. In this case, a competition authority may see it appropriate to raise the dominance threshold level to between 70 – 80% market share.

3.14 *Barriers to entry*—the ability of an undertaking to dominate a market is constrained to the extent that new entrants may easily enter the market. Put differently, a firm is said to dominate a market if it is able to act independently of competitive pressures, allowing it to charge higher prices profitably. If, however, barriers to entry are low, any action by the firm to increase prices – and therefore profitability –would attract new entrants who would put competitive pressures onto the undertaking, forcing it to reduce prices again. In this case, the firm cannot be considered to be dominant. On the other hand, if barriers to entry are high, entry is unlikely even if the market is highly profitable. In this case, the firm will be able to sustain high prices and profitability and can therefore be said to be dominant. High barriers to entry could exist for various reasons including licensing and regulatory requirements for entry (including patent rights) and high sunk costs.[9] Factors that would constitute barriers to entry would differ according to the case and circumstance.

3.15 In sum, a firm can be considered to be dominant if it has a market share of approximately 50% - the guideline threshold being dependent on circumstance – and there are high barriers to entry. An undertaking must be dominant for it to be able to predate successfully. Therefore, the investigation should continue on to the second step only if the undertaking is found to be dominant. If not, the investigation should stop and the conclusion would be that there is no predation.

Step 2: Analysis of prices and costs

[7] see Case C62/86, *AKZO Chemie BV v Commission* [1993] 5 CMLR 215
[8] OFT (1999), *The Competition Act 1998: The Chapter II Prohibition*, March.
[9] Sunk costs refer to the investments that have to be made to enable production of a good or service. These costs are incurred even before a single unit of good or service is produced. An example of sunk costs can be found in telecommunications where the cable network has to be put in place – at a high cost – before any voice or data transmission can be made.

3.16 If a firm is found to be dominant, the next step is to analyse the price-cost relationship so as to ascertain if predation did indeed take place. Following the guidelines set out by the competition authorities in the UK and Canada, it would be reasonable to use the following rules:

- A price at or above average *total* cost will not be regarded as unreasonably low;
- A price below average *variable* cost is likely to be considered predatory unless there is a clear justification such as the need to sell perishable inventory;
- Prices in the "gray range" between average total and variable cost require further investigation into the surrounding circumstances. Findings would be based on a case-by-case analysis. For example, a price in this range may be reasonable in situations of declining demand or excess capacity. It may be predatory if there was direct evidence of the undertaking's intent to predate. Other evidence on costs may also be considered, for example, whether the undertaking is covering its long-run avoidable costs.

3.17 Long run avoidable costs are costs that could be avoided if the undertaking were to cease the activity in question (the activity being the part of the business accused of predating). It would include both fixed and variable costs, but would not generally include:

- common costs (costs which may be attributed to a number of different activities). The undertaking may, however, be expected to cover common costs through the activities to which these costs contribute; or
- sunk costs, although sunk costs may be included in avoidable costs if they are incurred as part of the alleged predatory strategy, since the undertaking could then have avoided them by not incurring them.

3.18 In addition, an analysis of pricing behavior should also take into account the period and extent of predation. Specifically, below-cost pricing must be in effect for 'long enough' so as to be sufficient to inflict material harm upon competitors; otherwise it cannot be considered to be predation. Indeed, what is considered to be 'long enough' a time period differs from market to market. Similarly, below cost pricing on only a fraction of a product line cannot drive competitors out of a competitively meaningful market consisting of the entire product line. Such 'limited' action, therefore, would not constitute predation.

4. Entertainment Systems *vs* Telstar: An analysis

4.1 This section analyses the allegation of predatory pricing by Telstar using the principles outlined in section 3.

4.2 The investigation of predatory pricing in the cable market is carried out as follows. Following a definition of the relevant market, the two-step approach discussed in section 3 is implemented. Specifically, the dominance of the respondent is assessed and the price-cost relationship is analyzed.

Defining the Relevant Market

4.3 Before assessing whether a firm is dominant, the relevant market must be determined. This relevant market will have two dimensions - the relevant goods (i.e., the product market); and the geographic extent of the market (the geographic market).

4.4 *The product market*—the boundaries of the market are determined by taking the products relevant to the investigation and looking at the closest substitute products, those products which consumers would switch to if prices of the relevant products were to increase. These substitute products are included in the market if substitution by consumers would prevent prices of the products relevant to the investigation from rising above competitive levels. The alternative products do not need to be perfect substitutes, but alternatives that would fulfill a similar role to the goods in question, and to which consumers would switch in the event of a price increase. Essentially any similar goods that would prevent price-setting above competitive levels should be included in the definition of the relevant product market.

4.5 In addition to this substitution by customers (so-called "demand substitution"), prices can also be constrained by the potential behavior of suppliers of other products ("supply substitution). Businesses that are not currently supplying a particular product might switch some of their existing facilities to supplying that product (or close substitutes) if prices rose significantly.

4.6 An example of supply substitution may be found in the paper industry. Although low quality paper is often not considered to be a substitute for high quality paper, from a consumer's point of view, the different grades of paper are almost perfect substitutes from the producer's point of view. This is because the production methods are identical across all grades of paper where only the input (pulp) has to be changed in order to change the output from low to high quality paper. In this example, even though there is no demand substitutability, a rise in the price of high quality paper is likely to see paper manufacturers switching from low quality paper towards producing more high quality material. In other words, a similar product should be included in the same relevant market as the product in question as long as either demand or supply substitution applies.

4.7 *The geographic market*—Similar methods are used to define the geographic boundaries of a market. The geographic market will sometimes be the area supplied by the informant, or the parties to the conduct concerned. Consideration should also be given, however, as to whether customers could easily obtain similar products on reasonable terms from suppliers in other areas. If so, those other areas may form part of the geographic market. The geographic market may be a part of Jamaica, the whole of it, or may even extend beyond Jamaica.

The relevant market for cable television

4.8 *Product market*—the product market relevant to this case is the market for subscriber television (STV) service. While there are alternatives to STV such as Digital Satellite System (DSS), this requires a capital outlay that may prove prohibitive to consumers and is not considered as a close substitute in this analysis. On the supply side the stringent regulations that exist in the broadcasting industry precludes the easy set-up of other broadcasting entities.

4.9 Geographic Market— The geographic market for STV is determined by legal and technical factors. Specifically, the Broadcasting Commission has divided the market for the provision of STV service in Jamaica into zones and allows only two operators in each zone. Each operator can operate only in the zone for which it has been licensed. This means that each zone is a geographical market. Each zone consists of approximately 2000 households. With most of the St. Andrew area, where Telstar and Entertainment Systems operate, being almost fully populated, it is hardly likely that this market will grow. The relevant geographic market here is therefore, in general, the ten satellite zones in which Telstar was granted cable licenses and in which it currently operates, and specifically the four zones in which Entertainment Systems is the other licensee (i.e., its competitor).

Step 1: Assessment of dominance

Market Share

4.10 The greater the market share or the greater disparity in terms of the size of market shares between alleged predator and his competitors, the more likely it is that the alleged predator has market power. In this case the analysis revealed that Telstar's market share met the guideline threshold for dominance.[10]

Entry Barriers

4.11 Two types of entry barriers exist in the industry – licensing requirements and reputation effects. Both are considered below.

4.12 *Licensing requirements*—All cable TV providers require a licence before they can start operating Due to the division of the market into zones, potential operators have to make the applications specific to the zone(s) in which they wish to operate. The industry regulator, the Broadcasting Commission, assesses the applications and makes its recommendation to the Minister of Information, who will make the decision whether to grant the licence or not.

Licences are granted to companies that are incorporated in Jamaica and in which Jamaican/CARICOM nationals hold majority ownership and controlling interest. If after receiving a licence a company goes bankrupt its licence will be rescinded and resold to the most qualified person who applies to for that zone.

The application process for a licence as well as the need to invest in market-specific assets before start-up may impede/deter entry of new competitors.

[10] The data used to calculate the market shares is confidential company information and actual figures have therefore been omitted from this report.

Therefore if Telstar is successful in eliminating Entertainment Systems from the market it may be able to recoup its losses.

4.13 *Reputation effects*—eliminating the competitive threat posed by a particular rival will not secure increased market power if, other competitors are willing to and able to enter the market when the predator attempts to increase prices again. Predatory pricing, however, can derive reputation effects, which in turn serve as a barrier to entry, giving the predator time to recoup its initial losses. Potential entrants, on observing a firm's willingness and ability to engage in predatory pricing, and its result on the profitability of existing rivals are deterred from entering the market due to a fear of suffering a similar fate.

The high capital outlay that is required before a competitor can effectively enter the cable TV market as well as the limitation of a maximum of two cable providers per zone will make reputation effects extremely valuable to Telstar. If Telstar succeeds in eliminating Entertainment Systems from the market then it may be able to recoup losses through supra-normal profit.

4.14 In sum, both licensing requirements and reputation effects in the industry lead to high entry barriers. This, together with the finding of dominance of Telstar, implies that the investigation should proceed to step 2, where a price-cost analysis is performed (see below).

Step 2: Price-cost analysis

4.15 This phase of the analysis covers two steps – a financial analysis as well as an analysis of the duration of the alleged predatory behavior.

Financial analysis

4.16 In order to determine whether Telstar's special offer was below cost the following question was posed: *if* Telstar were to offer *all* its subscribers three months free rental, i.e., a reduction in revenues by 25%, would it still be profitable? If profits were still found to be positive even with a 25% reduction in revenues (costs remain the same), then the special offer would not be below cost.

4.17 Using financial data provided by Telstar, the Commission ascertained that a reduction of Telstar's revenue by 25% would not result in negative profits. This strongly suggests that *ceteris paribus* Telstar could offer three months free to all or some of it subscribers without making a loss. Hence, the special offer is not likely to have been below cost pricing.[11]

Duration of alleged predatory behaviour

4.18 The jurisprudence associated with the predatory pricing provision is clear that one must look at all the surrounding circumstances of low prices to distinguish between vigorous price competition and prices that may be predatory. One such circumstance would be the duration of the alleged activity. For the alleged activity

[11] The data used in the financial analysis is confidential company information and actual figures have therefore been omitted from this report.

to be deemed predatory it should take place long enough to cause material injury to the intended victim.

4.19 In the case of *Entertainment Systems vs. Telstar* the opportunity to pay the lowered prices was available only for the month of December. Given that Telstar's regular subscriber fee ($1000) was higher than that of Entertainment Systems' ($850) to start with, it is unlikely that Telstar would be able to take enough business away from Entertainment Systems to the point that the latter might be forced from the marketplace.

4.20 In light of the fact that Entertainment Systems is still a force in the STV market and is currently in the process of applying for a licence to enter one segment of the Telecommunications market one can infer that the scope and duration of the *alleged* abuse failed to produce an appreciable effect on competition. The offer made by Telstar in December 1999 would therefore not be said to be predatory.

Conclusion

4.21 The financial analysis, duration and effect of the alleged activity do not suggest that the Respondent, Telstar Limited, is guilty of predatory pricing. Specifically, the investigation finds that:

- the financial analysis indicates that the price in question is not below cost; and
- the duration of the alleged predatory activity was too short to have any appreciable effect on competition.

4.22 The special offer extended by Telstar is therefore not found to be predatory. Instead it is considered to be a form of *healthy* competition that is forcing its competitors to come up with better deals – either in the form of lower prices, better service, or both – which ultimately benefits the consumer. Such behavior should not be prohibited. On the contrary, it should be encouraged.